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SUBJECT: South Africa: Minerals and Energy Newsletter "THE ASSAY" - Issue 8, July 2008

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¶1. (SBU) Introduction: The purpose of this newsletter, initiated in January 2004, is to highlight minerals and energy developments in South Africa. This includes trade and investment as well as supply. South Africa hosts world-class deposits of gold, diamonds, platinum group metals, chromium, zinc, titanium, vanadium, iron, manganese, antimony, vermiculite, zircon, alumino-silicates, fluorspar and phosphate rock, and is a major exporter of steam coal. South Africa is also a leading producer and exporter of ferroalloys of chromium, vanadium, and manganese. The information contained in the newsletters is based on public sources and does not reflect the views of the United States Government. End introduction.

HOT NEWS

Moody's Downgrade for Eskom

¶2. (SBU) State utility Eskom has had its investment credit rating downgraded from A1 to Baa2 by Moody's rating agency. Moody's also lowered Eskom's baseline credit assessment from 8 to 13, 1 being the highest. This will make borrowing money on the capital markets more expensive, a cost that will inevitably be passed on to consumers. Eskom is in the middle of a $45 billion electricity upgrade and expansion program and believes it can raise $20 billion on local and global capital markets. Director General of the Treasury Department stated that the department was disappointed by the downgrade and was prepared to guarantee Eskom's existing debt and any new debt so as to ensure their access to money markets. Eskom said in a press statement that if the current economic climate continued and its capital expenditure program remained unchanged, annual tariff increases of between 20 - 25% would be needed over next three years. It should be noted that Eskom's downgrading does not affect South Africa's credit rating.

¶3. (SBU) Moody's downgrade occurred despite Eskom's generally improved situation. The SAG has advanced the disbursement of its $8 billion loan from five to three years; the National Energy Regulator has approved a tariff increase of 27.5% for 2008 and further increases determined by the costs of coal and diesel; and generation plants have performed well during the winter months with no significant unplanned outages. Eskom has cited the spike in coal

and diesel costs over the past year as putting a dent in their bottom line for the fiscal year ending March 31, 2008. Primary energy input costs accounted for 46% of running costs and rose by $700 million to $2.4 billion. Eskom has also appointed ex-CEO of AngloGold Ashanti Bobby Godsell as its new chairman, and Kumba Iron Ore CEO Ras Myburgh has been seconded to Eskom to help manage coal supply logistics, which were a major contributor to nationwide load shedding earlier this year. The appointment of the new executives is intended to help Eskom restore investor and public confidence. Eskom still has problems with coal availability and high prices, and also had to temporarily shut down one of the two units at its Qalso had to temporarily shut down one of the two units at its Koeberg nuclear power station because of technical problems in a generator. Latest developments are that the Koeberg unit is back on line, and Eskom is discussing borrowing up to $1 billion a year from the World Bank over five years, as it adjusts its funding strategy to cope with difficult global markets and ratings downgrades. These loans would be backed by government guarantees and be the largest yet extended by the World Bank to South Africa. The SAG has been reluctant in the past to accept World Bank funding.

MINING

Mining Output Up Again in Second Quarter

¶4. (SBU) Total mining production for the second quarter of 2008 increased by 7.7% compared with the first quarter. The increase was due to quarterly increases of 8.2% in the production of non-gold

minerals and 4.2% in the production of gold. The production of platinum group metals (PGMs) contributed 4.4% and diamonds contributed 1.5% to the 7.7% increase. Nickel was the only significant negative contributor (-0.1%) to the quarterly change in total mining production. Total seasonally adjusted value of mineral sales at current prices for the three months ended May 2008 reflect an increase of 23.8% compared with the previous three months. This increase of 23.8% (R15,272 million) can be attributed to an increase of 26.1% (R2,469 million) in the sale of gold and 23.5% (R12,803 million) in the sale of non-gold minerals. During the first quarter of the year, mining output fell by 22% due to power outages and mine closures for safety reasons and strikes.

ENERGY

Next Energy Crisis - Power Distribution

¶5. (SBU) The majority of South Africa's 187 electricity distributing municipalities have failed to maintain and upgrade their power distribution networks, preferring to use the electricity revenues to cross-subsidize other services and pay ample salaries to managers. In fact, the smaller independent municipalities lack financial, managerial and technical capacity to do their job efficiently. With the possible exception of major metropolitan centers, the country's distribution network is old (30-40 years), out-dated and in a poor state of repair. The SAG has been aware of this situation for more than a decade but has been unable to rectify the situation. This is mainly because of constitutional constraints and the unwillingness of municipalities and Eskom to voluntarily cede their power distribution function, assets, revenues, and staff to the proposed six Regional Electricity Distributors or REDS. In general, the SA Constitution grants municipalities the right to distribute electricity, and municipalities are not willing to give up their right to do so or the revenues generated therefrom.

¶6. (SBU) Government attempts to establish six country-wide REDs that would pool technical, financial and management capabilities and services, and harmonize electricity tariffs have met resistance from

many municipalities. Attempts to woo municipalities to voluntarily merge with the proposed REDs have failed mainly because government has not satisfactorily addressed municipal (and Eskom's) concerns regarding ownership structure of the REDs, compensation for assets incorporated in REDs, and the sharing of revenues generated by REDs. The six REDs were meant to be operational by end-June 2007, but none exist at present. Restructuring is extremely complex as it cuts across all spheres of government and needs constant consultations and persuasion. Unless there is a constitutional amendment to give national government power over electricity distribution, municipalities are likely to cling to their right to distribute power because it is their largest single source of income. Many municipal finances are in a mess and the lack of investment in electricity distribution could worsen and cause the Qinvestment in electricity distribution could worsen and cause the next power crisis.

SAG Promotes Nuclear Energy

¶7. (SBU) The SAG has approved a nuclear energy policy that promotes nuclear energy as a primary source of power generation. The cabinet statement indicated that the policy would also reduce the country's over-reliance on coal, which contributes to SA being a significant emitter of greenhouse gases. The Department of Minerals and Energy has been tasked to flesh out the practical details of the policy and oversee its implementation. Adoption of the policy will require the recapitalization of the National Nuclear Regulator (NNR) and the Nuclear Energy Corporation of SA (NECSA). NECSA's research and development budget will also need to be bolstered.

¶8. (SBU) Three new agencies are proposed under the policy: the National Nuclear Security Agency (to integrate the existing nuclear safety responsibilities into a single agency); the National Nuclear

Architectural Capability (to oversee the development of a national supplier network of nuclear equipment and nuclear reactors); and the National Radioactive Waste Management Agency (to manage radioactive waste). NECSA has been designated the lead agency in the implementation of this policy, while Eskom is the only power company allowed to build nuclear energy stations. According to the timelines provided in the policy, SAG hopes to encourage the establishment of local manufacturing capacity for nuclear equipment and components by 2015. It has also indicated potential interest in the reprocessing of spent fuel to manufacture additional feed for reactors.

ENVIRONMENT

SA Companies to Disclose GHG Emissions

¶9. (SBU) Over fifty SA companies are expected to disclose information about their carbon emissions, which will be incorporated into the world's largest databank of greenhouse gases (GHG) later this year. The exercise known as the Carbon Disclosure Project (CDP) was launched in 2007 with an initial target of 40 SA companies. The CDP project entails GHG emissions accounting, management, reduction and costing. Of the 40 companies targeted in 2007, only 15 provided quantitative data on emissions. Local CDP operators Incite Sustainability and National Business Institute observed that many companies now acknowledge that the carbon footprint issue affects business. SA firms in the agriculture sector and wine production are already feeling external pressure from importers and retailers, who demand to know the size of the exporters' carbon footprint. Targeted corporations include Sasol, BHP Billiton and Anglo-American.

Eskom to Implement Air Quality Safeguards

¶10. (SBU) Currently, state power utility Eskom only captures particulate emissions in its combustion stacks. Under pressure to also capture gaseous emissions, Eskom is finalizing tenders for a $700-million project to include flue gas desulphurization (FGD) technology in its Kusile (previously Bravo) power station, currently under construction near Witbank in Mpumalanga Province. This will be the first deployment of FGD technology in South Africa to remove sulfur from exhaust flue gases. Eskom CEO Jacob Maroga announced at a sod turning ceremony held at the site in August that Eskom was fitting FGD to Kusile to ensure compliance with air quality standards. The 4,800 megawatt coal-fired power station is to be ramped up in six 800-megawatt phases between 2013 and 2017, and will significantly reduce South Africa's power problems as it reaches completion.

¶11. (SBU) FGD technology is water-intensive, but was chosen as the preferred option in a trade-off between additional water usage and reduced atmospheric emissions in an area that already suffers from high levels of air pollution from coal-fired power stations. Eskom has signed a letter of intent with Anglo Coal to supply the plant
Qhas signed a letter of intent with Anglo Coal to supply the plant with 17-million tons of coal per year over Kusile's 47-year life. The coal is to be supplied by Anglo's empowerment subsidiary Anglo Inyosi Coal, with first coal deliveries expected in 2011 to build a stockpile before start-up of the first unit in 2013. Coal is likely be transported by a dedicated conveyor system, which will relieve pressure on the area's deteriorating road network.

GOLD

Power Rationing no Problem for AngloGold

¶12. (SBU) Eskom has followed through on its agreement to supply South Africa's deep level mines with 95% of their normal power

demand. This level was negotiated as the minimum necessary for mines to maintain production levels in a situation where 50% of the power is needed to supply essential services of ventilation, cooling and pumping water from underground. AngloGold Ashanti's Quarterly Report to Shareholders for the end of June 2008, stated that Eskom had maintained a steady power supply of 96.5% during the second quarter and that the company had successfully operated at full production using less than 94% of the power supplied. This means Anglo has reduced its normal power requirements by 10.3%.

¶13. (SBU) At a meeting with Anglo in January, on the eve of Eskom's force majeure to the mining industry, Anglo management stated that their aim was to cut power consumption by as much as 17% over time and still maintain full output. They appear to be moving quickly toward that goal. Cuts by the mining industry have been good for the country as a whole and this winter has not seen any power outages of significance. Eskom may have achieved their goal of providing consistent power throughout the winter months, which in SA is mid-April to mid-September.

Gold Fields in Safety Fix

¶14. (SBU) The world's fourth biggest gold producer Gold Fields will lose about 12% of its South African production in the current financial year after a safety check revealed that it needed to make substantial repairs to the main shaft at its nearly 4000-meter deep Kloof Mine. Safety is a top priority for mining groups in South Africa after a spate of mining deaths in the past year, and government's response of closing mines for days following fatalities. One of the worst accidents happened in May, when a lift cable snapped at Gold Fields' South Deep Mine, killing nine miners. New CEO Nick Holland said at the year-end results presentation that a review of infrastructure at the entire group's South African mines showed that the steelwork in the main shaft of the 40-year old Kloof

Mine had deteriorated and needed repair.

¶15. (SBU) Analysts were generally positive about Gold Field's decision, but noted that closures due to maintenance backlogs could become industry-wide and impact on both costs and production in an industry with shrinking margins. Gold Fields also announced that it had switched to fully mechanized mining at its 3,000-meter deep South Deep Mine, necessitating a voluntary lay-off scheme for 1,885 workers. The company offered miners relocation to its other mines, but a National Union of Mineworkers spokeswoman said the workers refused to be redeployed to Kloof and Beatrix mines because of their "poor safety records." She said that miners would rather go home than risk their lives in those mines.

Hope Flickers for the Gold Industry

¶16. (SBU) The South African gold industry, which accounted for 80% of world production as recently as 1970, could decline gracefully over the next 40 years, if challenges are managed well. This statement was made in The Fortis Yellow Book, a publication by Qstatement was made in The Fortis Yellow Book, a publication by Virtual Metals on gold supply and demand. It says South Africa still has a large amount of technically accessible gold underground, of which 8,000-10,000 tons can be profitable at current prices. The prospect of a consistently high gold price in rand terms might encourage long-term development (decades instead of years), despite the fact that it is difficult and costly to access the deep resources. Further, the book states that new industry leaders face a number of challenges, including an unreliable power supply, rising costs, labor strikes, lack of skills, demanding shareholders, government intervention, political leadership, and the challenging issue of safety, but with hard work and co-operation the challenges are manageable.

¶17. (SBU) On the negative side, the publication said that increased capex investment of $1.08 billion in 2007 and $811 million in 2006 was not sufficient to ensure the long-term expansion of the gold industry. These investments would only slow the pace of decline in production over the next three to five years. South Africa has

world-class gold deposits, but they are extremely deep and require mining as deep as four kilometers to exploit them. The deep underground environment involves ambient rock temperatures of 55 degrees Celsius, and a higher risk of seismic activity. Huge costs are incurred in mining these deposits and require an investment horizon measured in decades, as opposed to the short-term horizon of current shareholders who wanted to see monthly or quarterly results. The risk to the country's gold mining sector is rising costs and not the lack of gold resources in the ground.

Party Over for Precious Metals and Miners?

¶18. (SBU) JPMorgan has reduced its price forecast for platinum group metals (PGMs) due to the worsening economic situation. The gold price has also fallen, said to be due to the strengthening U.S. dollar. Johannesburg-based analysts have said that despite the wide range of uncertainties, they would not alter their positive longer-term view on platinum. Since July 1 the price of PGM metals has fallen precipitously - platinum and rhodium by 28%, and palladium by 32%. Gold has also slipped by 13%. A combination of clean-air legislation, restricted supply of PGMs, and lack of alternatives for the control of auto exhaust emissions, makes it virtually certain that demand and prices for PGMs will increase when the global "recession" eases. The question is, when will this happen, and for South Africa, what impact will the lower prices have on the large number of new PGM projects being development? The concern is that junior miners developing relatively low-grade platinum mines may not have sufficient financial backing to see them through a sustained (or even a short) downturn in PGM prices.

DIAMONDS

Element 6 is not Diamond Science Fiction

¶19. (SBU) Contrary to popular belief, diamonds have a much more important role to play than simply being "a girl's best friend". Diamonds have hardness, electrical and heat conductivity, and many other properties that make them indispensable to modern high-tech industries. These are the so-called "industrial diamonds" or non-gem quality stones known as boart that generally make up the majority of stones produced by mines. Boart is of inferior quality and mainly used for cutting and polishing gem diamonds and other hard materials. Decades ago De Beers began research on making high quality synthetic stones for industrial use. Research turned into production and now the majority of industrial stones are manufactured and not mined. De Beers established manufacturing plants globally, but about eight years ago the company moved much of its production to its new, world-class research and manufacturing plant in Springs, some 45 kilometers east of Johannesburg. The plant was called Element 6, the atomic number for Carbon, which is the chemical make-up of diamond. It is jointly owned by De Beers Qthe chemical make-up of diamond. It is jointly owned by De Beers (60%) and Belgian minerals group Umicore (40%). Element 6 has a turnover of almost $500m a year and supplies synthetic diamonds and other super abrasives to the engineering industry, mainly for use in cutting tools.

¶20. (SBU) Element 6 launched a $100 million private equity fund in March to invest in companies using artificial diamonds in innovative ways. It has made four investments so far and is expected to close another four deals in the next few months, according to E6 Ventures head Brendon Grunewald. He said the fund invested in companies doing innovative things with diamonds rather than new technologies. There has been much interest in using synthetic diamonds in a range of new applications, from electronics to medical devices. One of the companies in which the fund has invested is Advanced Oxidation, a British company that uses artificial diamonds to generate electrical current to degrade chemical pollutants. Element 6's website mentions its investments in the company Diamond Microwave Devices, which is developing diamond semiconductor materials and processing technology for civil and defense systems. It also

mentions the company Diamond Detectors, which uses synthetic diamonds in sensors for high-energy physics, ionizing radiation and deep ultraviolet monitoring.

COAL

Mozambique to Export Coal in 2010

¶21. (SBU) Mozambique plans to export coal in 2010 after completing the rehabilitation of the 665 kilometer Sena rail line from the Moatize coal fields in Tete Province to the port city of Beira. The project began in 2002. Repairs are being carried out by an Indian consortium, which has a 51% stake and Mozambique's Ports and Railways Company (CFM), which holds the remaining 49%. The $475 million project cost is being paid through a World Bank loan. So far the Mozambican authorities have issued 125 licenses for coal exploration, mostly in western Tete Province and the northern-most province of Niassa. The Sena line has been allocated 8 million tons of coal per year, which is below the combined estimated mine output of 40 million tons of coal per year. The railway will also carry 18 million tons of freight per year, consisting of various products including sugar and cement.

¶22. (SBU) Three companies have committed to develop Mozambique's extensive coal resources. Brazil's Vale, formerly Companhia Vale do Rio Doce (CVRD), is investing over $2 billion to build a mine on its

25-year concession at Moatize, which has an estimated resource of 2.4 billion tons of coal. Australia's Riversdale Mining plans to invest $2.1 billion to mine its concession at Benga, near Moatize, which has an estimated resource of 1.9 billion tons of coal. The third company is Changara Investments, a subsidiary of London-based CAMEC (Central African Mining and Exploration Company), which has an estimated resource of over 900 million tons of coal in its concession west of the Zambezi river. Coal production is conditional on the opening of the Sena rail line to provide access to the port of Beira for export.

BOST